K&L GATES

Registered Funds and the New Names Rule Proposals: What You Need to Know and Why You Need to Comment Now

Fatima S. Sulaiman, Partner, K&L Gates LLP
Michael W. McGrath, Partner, K&L Gates LLP
Jon-Luc Dupuy, Partner, K&L Gates LLP
Cal J. Gilmartin, Associate, K&L Gates LLP

© Copyright 2022 by K&L Gates LLP. All rights reserved.

Historical Application of the Names Rule

- As adopted in 2001, the Names Rule requires an 80% Policy for funds with names suggesting
  - Certain types of investments or industries (e.g., equity, health care)
  - Certain countries or geographic regions
  - Tax-exempt distributions
- Proposed amendments motivated, in part, by concerns over “greenwashing”
- Capture other terms that historically have been considered investment strategy terminology outside the scope of the rule

Overview of proposal

- SEC has proposed amendments to Rule 35d-1 under the 1940 Act (the Names Rule) covering the use of certain terms in the names of registered investment companies
  - Expand the scope of terms considered to be materially deceptive and misleading in a fund's name without a corresponding 80% Policy
  - Require additional disclosures regarding how a fund selects investments that fit the terms used in its name
  - Limit the types of investments a fund can make outside of its 80% Policy

Overview of proposal

- Narrow the length of time and circumstances in which a fund may depart from its 80% Policy
- Shift away from time of investment to daily compliance regime to curb portfolio drift
- Impose strict standards for how a fund must calculate the value of derivatives exposures
- Impose new requirements on unlisted closed-end funds and business development companies (BDCs)
- Modify the Names Rule’s notice, recordkeeping, and reporting requirements

Comment overview

- The comment period for the Proposed Amendments closes on August 16
- If adopted, a one-year transition period is proposed for compliance with all elements of the Proposed Amendments
- Comments should focus on substantive areas of greatest concern to the individual fund complex
  - Definitions or additional guidance on meaning or application of particular terms used in the release
  - Potential need for more flexibility in testing for or departures from 80% Policies and investments outside of 80% Policies

Expansion of Scope: Particular Characteristics

As proposed, the Names Rule would be expanded to apply to terms suggesting a fund focuses in investments that have, or whose issuers have, "particular characteristics"

Terms Covered by Proposed Expanded Scope of the Names Rule	Terms That Would Continue to be Excluded from the Names Rule
Growth/Value	Characteristics of a fund's objective or portfolio as a whole (Duration, Balanced)
ESG Factors	Elements of an investment thesis or technique without specificity as to the particular characteristics of the component portfolio investments (Long/Short)
Global/International	A possible result to be achieved (Real Return)
Income	A retirement target date
Intermediate Term (or similar) Bond	

MATERIALLY DECEPTIVE OR MISLEADING NAMES

- Technical compliance with an 80% Policy is not a safe harbor
  - The “20% basket” may not include a “substantial investment” that is “antithetical” to the fund’s investment focus
  - A substantial portion of the fund’s risks or returns may not be different from that which an investor reasonably would expect based on the fund’s name
  - An index tracking fund may violate the Names Rule despite investing 80% or more in the index, if the underlying index has components that are contradictory to the index’s own name
  - A fund that is perpetually out of compliance with its 80% Policy may violate the Names Rule even if such departures are temporary and otherwise permissible under the Proposed Amendments

Departures from an 80% Policy: Specific Circumstances

- Shift from requiring compliance with an 80% Policy "under normal circumstances"
- Funds would only be permitted to depart from an 80% Policy under specific circumstances:
  - Market fluctuations or circumstances not caused by purchase/sale of security or entering/exiting an investment
  - Unusually large cash inflows or redemptions
  - To take a position in cash, cash equivalent, or government security positions to avoid loss in response to adverse market, economic, political, or other conditions
  - During certain fund events (liquidations, reorganizations, fund launches and when the fund has given 60 days notice of a name and 80% Policy change)

Departures from an 80% Policy: How Measured

- Would require Funds to return to compliance with their 80% Policies as soon as reasonably practicable, but in any event within 30 consecutive days
- Shift from requiring testing for compliance with an 80% Policy at time of investment to daily compliance to curb portfolio drift
- Would require Funds to track compliance with 80% Policies at least daily, with detailed records demonstrating the assessment of each security position counted towards the 80% basket

Derivatives: Notional Value

- Funds are required to use notional value for all derivatives instruments, rather than market value, when calculating compliance with an 80% Policy
- Required to reduce the value of net assets in the “denominator” of the 80% Policy calculation by excluding cash and cash equivalents up to the notional amounts of derivatives
- Notional amounts must be converted to 10-year bond equivalents for interest rate derivatives and delta adjusted for options contracts

Derivatives: Counted Towards 80% Policy

- Funds may count derivatives instruments towards 80% Policy compliance if the position provides investment exposure to:
  - Investments suggested by the fund's name
  - One or more of the market risk factors associated with the investments suggested by the fund's name (interest rate risk, credit spread risk, foreign currency risk)
- SEC believes notional value would better reflect the investment exposure connected to individual derivatives instruments
- Notional value requirement adds an additional, different calculation requirement to '40 Act rules

Unlisted Closed-End Funds and BDCs

- Registered closed-end funds or BDCs whose shares are not listed on a national exchange would be required to adopt fundamental 80% Policies to comply with the Names Rule
- Prohibited from changing a Names Rule 80% Policy without a shareholder vote

Disclosure Requirements

- Amendments to fund registration forms require funds with 80% Policy to include additional disclosures
  - Forms N-1A, N-2, N-8B-2, S-6, and N-PORT
  - Define in the prospectus the terms in the fund's name related to its investment focus or strategies
  - Include any specific criteria the fund uses to select the investments that each term describes
  - Definitions should be consistent with the term's "plain English" meaning or established industry use
  - Where fund name suggests focus in multiple types of investments or strategies, 80% Policy must address all elements in the name
    - "ESG" funds must address all three terms, rather than a single element

Recordkeeping and reporting

- All funds required to maintain records documenting compliance with the Names Rule
  - Which investments are counted towards 80% Policy and basis for their inclusion towards 80% Policy
  - Reasons for any departures from an 80% Policy, dates of departure, and related shareholder communications
  - Funds without an 80% Policy required to maintain a written record of their analysis as to why such a policy is not required under the Names Rule
- Amendments to Form N-PORT
  - The value of the fund's 80% basket, as a percentage of the value of the fund's assets;
  - Whether each portfolio investment is included in the fund's 80% basket at the end of the period; and
  - If applicable, the number of days that the value of the fund's 80% basket fell below 80% of the value of the fund's assets during the reporting period

Questions?

What's next?

- **Registered Funds and the New ESG Rule Proposals: Everything You Wanted to Know But Were Afraid to Ask**
    - June 23, 2022
    - 2:30 - 3:30 P.M. ET

Comments/Suggestions

- We welcome your feedback on this program and encourage you to let us know of any questions or topics to discuss in our subsequent webinars and client alerts.
- Also, please let us know if you would like to be connected to any of our presenters.
- Contact: brooke.erickson@KLGates.com

K&L GATES